California Independent
System Operator Corporation

Memorandum

To: ISO Board of Governors

From: Steve Berberich, Vice President of Technology and Corporate Services and Chief Financial Officer

Date: October 21, 2009

Re: **Decision on Extension of Current Grid Management Charges through 2010 with a Modification to the Market Usage Forward Energy Charge**

This memorandum requires Board action.

Executive Summary

The California Independent System Operator Corporation's (ISOs) current grid management charge (GMC) became effective with the new market implementation on April 1, 2009 and will expire by its own terms on December 31, 2009. Therefore, the grid management charge must be extended through December 31, 2010. Management proposes to extend the grid management charge formula rate and the current rate design elements, except for a modification to the market usage forward energy charge which represents about 6.6% of the 2010 revenue requirement.

The current grid management charge rate design was approved by the Federal Energy Regulatory Commission (FERC) on December 19, 2008. At the ISO's June 17, 2009, budget meeting, the ISO proposed to extend the grid management charge rate elements and the current revenue requirement cap through 2010, subject to the outcome of a separate stakeholder process to consider the imposition of grid management charges on inter-scheduling coordinator trades, an issue that previously had been raised in a FERC proceeding. Based on stakeholder comments and cost causation principles, Management proposes to eliminate inter-scheduling coordinator trades as a market usage forward energy charge billing determinant, and to apply the charge to all physical energy in the day-ahead market using the greater of a scheduling coordinator's supply or demand volume. The ISO will propose to extend the grid management charge and modify the market usage forward energy charge in a tariff amendment to be filed with the FERC by November 1, 2009.

Management is proposing the following motions:

> ***Moved, that the ISO Board of Governors approves the proposed tariff changes regarding the extension of the grid management charge through December 31, 2010 and modifications to the grid management charge market usage forward energy charge, as detailed in the memorandum dated October 21, 2009; and***
>
> ***Moved, that the ISO Board of Governors authorizes Management to make all of the necessary and appropriate filings with the Federal Energy Regulatory Commission to implement this proposal.***

DISCUSSION AND ANALYSIS

Grid Management Charge Background

The basic design of the grid management charge, which is the mechanism through which the ISO recovers its administrative costs, was established in a settlement agreement with stakeholders in 2004 and approved by the FERC in 2005. That design consists of a rate formula that allocates costs to categories that correspond to ISO services, subject to an annual revenue requirement cap. As long as the ISO's revenue requirement remains below the cap, the ISO and market participants have agreed that a regulatory filing reflecting changes to the annual revenue requirement is unnecessary. The 2004 settlement contemplated that the formula rate and revenue requirement cap would remain in place until the earlier of the ISO's new market *go live* or the end of 2006. Because the new market *go live* date was extended several times after 2006, the ISO and its stakeholders agreed to extend the grid management charge formula rate and revenue requirement cap in 2006, 2007 and 2008. The 2008 extension filing provided that the grid management charge would expire on December 31, 2009, and this provision remained in place upon new market implementation. Through a stakeholder process in 2009, market participants again agreed to extend the GMC formula rate and revenue cap through 2010, subject to the changes noted in this memo. Upon Board approval, the ISO will file to extend the current GMC construct through 2010.

Extending the Current Grid Management Charge

Except for a change to the market usage forward energy charge, discussed below, Management proposes to extend the current grid management charge formula rate and the $197 million revenue requirement cap until January 1, 2011. Accordingly, the tariff change needed to implement this extension is restricted to one paragraph of the tariff, in *Appendix F*, *Schedule 1, Part D*. The sole change consists of changing the reference of the year from "2010" to "2011."

Modifications to the Market Usage Forward Energy Charge

As indicated above, Management proposes to modify the market usage forward energy charge. To understand the proposed modifications to this charge code, it is necessary to understand what costs the charge is intended to recover. The market usage forward energy charge is designed to recover, *inter alia,* costs for systems and operations associated with running the forward market. The charge is based on total megawatts scheduled in the forward market, and the current formula nets a scheduling coordinator's supply and demand volume, then subtracts the MWh's of inter scheduling coordinator trades (ISTs) to apply the charge calculation.

Stakeholders questioned whether it was appropriate to apply the market usage forward energy charge to ISTs when they were just executing ISTs in the day-ahead market and not actually scheduling physical energy. Subsequently, certain parties filed protests with the FERC. Certain stakeholders were alleged that the rate was unreasonable when applied to market participants that were only executing ISTs and would result in an over collection of ISO costs. Stakeholders also questioned whether netting physical energy appropriately reflected the ISO's costs for running the forward market. As the ISO monitored collections under the new market, over collection conditions did develop and the ISO reduced the market usage forward energy charge on August 1, 2009 (from $0.43 per MWh to $0.30 MWh) and October 1, 2009 (from $0.30 MWh to $0.26 MWh).

The ISO addressed the issue of application of the charge to ISTs in the day-ahead market in a stakeholder proceeding that was initiated on August 3, 2009 when the ISO posted an issue paper posing two options for consideration. The ISO subsequently discussed these options at an August 18, 2009 stakeholder meeting.

Both options contemplated removing ISTs from the billing determinants to which the market usage charge code formula applies. Accordingly, ISTs would no longer be netted against all energy trades in the day-ahead market and would be only subject to a flat fee per schedule. However, the two options differed with regard to whether the market usage forward energy charge would continue to be applied to "net" energy (the product of netting supply and demand) or to "gross" energy consisting of all energy (the product of gross supply and demand) in the day-ahead market.

Based on stakeholder comments and a financial impact analysis provided to individual participants, the ISO posted a straw proposal on August 28, 2009 suggesting that the "netting" option was the most appropriate approach. Both options resolved stakeholder concerns by removing inter-scheduling coordinator energy trades from the market usage forward energy charge formula, but applying the charge to "gross" energy resulted in substantial bill impacts to certain market participants. The ISO noted that while the "gross" option better reflects cost causation principles, significant bill impacts should also be taken into consideration. A second stakeholder meeting was held on September 15, 2009, to discuss the straw proposal.

In comments and at the meeting, some stakeholders expressed their support for the netting option, but the majority took issue with the ISO's proposal to continue netting. These stakeholders suggested that rather than continue netting supply and demand, the ISO should adopt a mitigation solution that would reduce bill impacts while retaining the cost causation principles reflected by the gross energy option. Specifically, Powerex proposed that the "gross" approach be adopted, but for those scheduling coordinators with both supply and demand the market usage forward energy charge would be applied to the "greater of" their supply or demand MWhs in the day-ahead market.

Following the September 15 stakeholder meeting, ISO staff verified that the "greater of" mitigation solution proposed by Powerex was feasible and could be implemented in the ISO settlements system. Staff informally contacted almost all interested stakeholders, particularly those with both supply and demand in their portfolio, to discuss this mitigation approach. In addition, the ISO held a stakeholder conference call on September 30, 2009, to provide stakeholders an additional opportunity to discuss the proposal and ask questions. Following those consultations and the public meeting, the ISO posted its final proposal on October 2, 2009, in which it proposed to:

1) Eliminate inter-scheduling coordinator trades from the market energy forward usage charge code calculation;

2) Eliminate "netting" forward energy from the calculation; and

3) Implement the "greater of" mitigation solution in the market usage forward energy calculation.

The ISO agreed that the "greater of" mitigation solution would remain in place on an interim basis until the ISO undertakes a new cost of service study and considers, with its stakeholders, necessary changes to the grid management charge rate design. On October 12, 2009, interested parties submitted comments on the final proposal.

POSTIONS OF THE PARTIES

At the initial June 17, 2009 budget meeting, the July 22, 2009 grid management charge meeting and again at the October 1, 2009 budget meeting, Management informed stakeholders of the proposal to extend the current tariff provisions (except for the change to the market usage forward energy charge) through 2010. Stakeholders were provided an opportunity to submit comments regarding the extension proposal at each meeting. In response, parties specifically requested that the extension request be limited to the year 2010. Certain parties also advised the ISO that if the market usage forward energy charge issue was not satisfactorily resolved, they would oppose the grid management charge extension proposal. Stakeholders did not raise any other issues regarding the grid management charge extension.

The ISO conducted the market usage forward energy initiative as a separate process, and stakeholders had three opportunities to submit written comments for consideration, in addition to providing comments at two stakeholder meetings and one conference call. Aside from eliminating ISTs from the market usage forward energy charge calculation, there was no consensus among stakeholders regarding the netting and bill impact mitigation issues.

Stakeholder comments on the final proposal for market usage forward energy charge are detailed in the attached stakeholder matrix.

MANAGEMENT RECOMMENDATION

There is broad support to eliminate ISTs from the billing determinants used to calculate the charge for market usage forward energy, and Management recommends that change. However, there is no consensus on how the charge should be structured for the actual amount of physical energy scheduled. Some scheduling coordinators stated that removing ISTs from the charge is sufficient to resolve the issue, and that netting physical energy should remain on the basis of FERC already approving that methodology and that the balanced part of a portfolio does not play a role in the forward market. However, Management believes that all MWh's of physical energy scheduled in the day-ahead market do factor into the integrated forward market calculations and should therefore be subject to this charge from a cost causation standpoint. The gross quantity of a scheduling coordinators supply plus demand must be processed through SIBR and addressed by the market optimization in order to perform congestion management, irrespective of whether that supply and demand was economically bid, self-scheduled, or was scheduled under an existing transmission contract. The ISO acknowledges that shifting to a gross calculation at this time would create a significant cost shift to those scheduling coordinators with both supply and demand in their portfolio. To mitigate the bill of a shift from net to gross, the ISO is proposing the "greater of" approach as a solution. The "greater of" proposal will only look at the larger of an SC's supply or demand MWh's in their portfolio and assess the charge on that basis, rather than the sum of their supply and demand.

Management's proposed solution accomplishes the objectives of redesigning this charge code while considering the impacts to all market participants. It removes ISTs from the equation, while also mitigating the bill impact through a "greater of" methodology. This solution is intended to be in place until a full cost of service study is completed in the future.